SMU Dedman School of Law

SMU Law Review

Volume 24 | Issue 2 Article 8

1970

Texas Professional Associations - Planning Considerations Prior to Formation and Tax Status under Recent Legislation

Dan M. Cain

TEXAS PROFESSIONAL ASSOCIATIONS — PLANNING CONSIDERATIONS PRIOR TO FORMATION AND TAX STATUS UNDER RECENT LEGISLATION

by Dan M. Cain

With the recent concession by the Internal Revenue Service (hereinafter referred to as IRS) that organizations of doctors, lawyers, and other professionals authorized under state professional association or corporation laws will be treated as corporations for tax purposes,[1] many such professionals will be influenced to seek the tax benefits accompanying the corporate structure. This IRS acquiescence will be strongly felt in Texas due to the recent enactment of the Texas Professional Corporation Act[2] and the Texas Professional Association Act.[3] The TPAA permits professionals to form an association for tax purposes,[4] and the TPCA allows professionals to incorporate for the same purposes. Doctors are the only professionals excluded from the TPCA.[5] All other professionals, having a choice of either Act, will undoubtedly choose the TPCA because corporation law is to apply to organizations under this Act unless inconsistent with the Act's basic provisions,[6] while the TPAA subjects associations to partnership law for situations not covered in the Act.[7] This resort to partnership law makes a Texas association's status for tax purposes somewhat questionable.[8] This Comment will: (1) trace the historical background and development of professional associations, culminating in the recent IRS acquiescence; (2) discuss the advantages and disadvantages of these organizations; (3) suggest planning considerations to be used in forming an association; and (4) apply to Texas associations the criteria used by the IRS in determining if an organization has the necessary characteristics of a corporation[9] to qualify for corporate tax treatment.

I. Background and Historical Development of Professional Associations

Background. Compared to corporations and associations, the professional

---

[1] Technical Information Release No. 1019 (Aug. 8, 1969).

[2] Tex. Laws 1969, ch. 779, at 2304, to be codified as TEX. REV. CIV. STAT. ANN. art. 1528e, §§ 1-20 (Supp. 1970) [hereinafter referred to in text and footnotes as TPCA].

[3] Tex. Laws 1969, ch. 840, at 2513, to be codified as TEX. REV. CIV. STAT. ANN. art. 1528F, §§ 1-24 (Supp. 1970) [hereinafter referred to in text and footnotes as TPAA].

[4] Although both the TPCA and the TPAA recite that their purpose is to permit incorporation or association for the purpose of rendering a "professional service," their primary purpose obviously is to obtain federal tax benefits for their members. This legislative tactic is not new and has been used in other jurisdictions. For an excellent discussion, see Comment, *The Illinois Professional Association Act*, 57 NW. U.L. REV. 334 (1962).

[5] TPCA § 3(a).

[6] *Id.* § 5.

[7] TPAA § 24.

[8] *See* notes 122-27 *infra*, and accompanying text.

[9] These characteristics were originally set out in Morrissey v. Commissioner, 296 U.S. 344 (1935), and subsequently adopted as part of the well-known "Kintner Regulations." Treas. Reg. § 301.7701(a)(e), T.D. 6503, 1960-2 CUM. BULL. 409.

partnership[10] has long received unfavorable tax treatment under the Internal Revenue Code.[11] This discrimination is easily observed by a brief discussion[12] of several Internal Revenue Code provisions.

Corporations may deduct contributions on behalf of an employee to a qualified pension and profit-sharing plan.[13] This contribution is not income to the employee until received[14] and the investment income of the plan is tax exempt until distributed and may be reinvested tax free.[15] Premiums paid by a corporation for employee group life, health, and accident insurance policies are a deductible expense of the corporation[16] and are not considered as income to the employee.[17] In addition, the corporation may pay the employee or his dependents up to five thousand dollars as reimbursement for medical expenses, and such payments are tax free to the employee.[18] A professional in a partnership cannot obtain these benefits because he is not considered by the Internal Revenue Code to be an employee for tax purposes.[19] From this introduction, it is understandable that professionals have sought to obtain corporate tax status. The Keogh Bill[20] has somewhat weakened the motivation for professional incorporation, but there remain substantial benefits that are denied to the self-employed professional.[21]

Historical Development of the Professional Association. Professionals originally sought to obtain the existing corporate tax advantages by reliance on the IRS position that corporate status was to be imposed on entities that achieved the necessary corporate characteristics, either by agreement or as

[10] This discussion is primarily concerned with the professional partnership, but it is equally applicable to all partnerships and self-employed individuals. These organizations differ from the professional partnership in that they have no legal or ethical considerations prohibiting incorporation as do professional partnerships in the absence of special legislation.

[11] *See generally* Eaton, *Professional Corporations and Associations in Perspective*, 23 TAX L. REV. 1 (1967); Rapp, *The Quest for Tax Equality for Private Pension Plans: A Short History of the Jenkins-Keogh Bill*, 14 TAX L. REV. 55 (1959); Wormser, *A Plea for Professional Incorporation Law*, 46 A.B.A.J. 755 (1960); Comment, *Professional Associations and Professional Corporations*, 16 Sw. L.J. 462 (1962).

[12] This discussion is intended for purposes of introduction only. For a more extensive treatment of these and other Code provisions, see text accompanying notes 52-94 *infra*.

[13] INT. REV. CODE of 1954, § 404.

[14] *Id.* § 402(a)(1); Treas. Reg. § 1.402(a)-1, T.D. 6887, 1966-2 CUM. BULL. 129.

[15] INT. REV. CODE of 1954, § 501(a); Treas. Reg. § 1.501(a)-1, T.D. 6500, 1960-2 CUM. BULL. vii (T.D. 6500 was issued as a consolidation of existing regulations and is not published in the Internal Revenue Bulletin. These regulations are scattered throughout the Code of Federal Regulations).

[16] INT. REV. CODE of 1954, §§ 79, 101, 104, 105.

[17] *Id.* § 106.

[18] *Id.* § 105.

[19] *Id.* § 7701(a)(20).

[20] The Self-Employed Individuals Tax Retirement Act of 1962, 26 U.S.C. § 2039 (1964). For a critical discussion of this Act, see ABA SECTION ON REAL PROPERTY, PROBATE AND TRUST LAW PROCEEDINGS, REPORT OF THE COMMITTEE ON PENSION AND PROFIT-SHARING TRUSTS 134-54 (1963).

[21] For example, a professional is limited to a maximum investment of $2,500 under a "Keogh" plan, but may invest up to 15 per cent of his salary in a qualified corporate profit-sharing plan. Also, payments into a plan for both profit-sharing and pension benefits are included in the $2,500 maximum authorized under a "Keogh" plan, while amounts in excess of 15 per cent of income may be invested in a qualified corporate plan if pension benefits are included. For an extensive discussion of the tax benefits under each type plan, see Ray, *A Comparison of Tax Benefits Available under HR 10 with Those Provided by Professional Associations*, 26 GA. B.J. 269 (1964).

a matter of law.[22] Since corporate status was imposed on at least one medical clinic,[23] the IRS apparently felt that the activities of professionals qualified as normal business operations.[24]

One of the first attempts by the IRS to disallow corporate status for a professional association was in the landmark case of *United States v. Kintner*.[25] In this case, a group of eight doctors had dissolved their general partnership and had entered into articles of association, seeking to become members of an unincorporated common law association and thereby entitled to corporate tax status.[26] They provided for continuity of life, centralized management, and a form of limited liability.[27] The association then created a pension trust for the benefit of its employees. This action was based on the belief that the organization qualified as a corporation under the IRS test. The IRS argued, however, that since the doctors could not incorporate under state law,[28] they could not be considered a corporation for federal tax purposes. The court of appeals for the Ninth Circuit, relying on the attributes of continuity, centralized management, and the government's prior position of allowing such associations corporate tax status, held that state law did not determine the status of an entity for tax purposes and that the organization's "substantial corporate characteristics" qualified it as an association.[29] The *Kintner* decision set the stage for an attempt by the IRS to sustain its new position by changing the regulations pertaining to corporate status.

Although *Kintner* was not appealed to the Supreme Court, the IRS announced that it would not follow the ruling,[30] and in 1960 adopted regulations, commonly known as the "Kintner Regulations," which outlined the test to be employed in determining whether an unincorporated organization should be taxed as a corporation.[31] These regulations provided that if an organization's corporate characteristics exceeded its noncorporate characteristics, it was to be taxed as a corporation. The characteristics mentioned were: (1) a composition of associates whose purpose was to carry on a business and share in the profits; (2) centralized management; (3) continuity of life; (4) limited liability; and (5) free transferability of ownership interests.[32] The regulations also took the position that even the presence of two or more corporate characteristics did not guarantee corporate tax treatment.[33]

[22] *See* Overbeck, *Current Status of Professional Associations and Professional Corporations*, 23 Bus. Law. 1203, 1204 (1968).

[23] Pelton v. Commissioner, 82 F.2d 473 (7th Cir. 1936).

[24] *See* Overbeck, *supra* note 22, at 1205. It has also been argued that the activities of these professionals began more closely to resemble corporations in their operations due to the increase in group medical practice in the 1930's. Annot., 4 A.L.R.3d 383, 386 (1965).

[25] 216 F.2d 418 (9th Cir. 1954).

[26] Corporate tax status would be possible because a common law association is included in the Code definition of the term "corporation." Int. Rev. Code of 1954, § 7701(a)(3).

[27] 216 F.2d 418, 420 (9th Cir. 1954).

[28] *Id.* at 421.

[29] *Id.* at 422-24. The corporate characteristics the court mentioned were those originally set out in Morrissey v. Commissioner, 296 U.S. 344 (1935).

[30] Rev. Rul. 56-23, 1956-1 Cum. Bull. 598.

[31] Treas. Reg. §§ 301.7701-1 to -4, T.D. 6503, 1960-2 Cum. Bull. 409.

[32] *Id.* § 301.7701-2(a)(1).

[33] *Id.* § 301.7701-2(a)(2).

If the IRS had merely listed the criteria to be applied, the "Kintner Regulations" would have presented little difficulty, since most professionals could have amended their articles of association to comply with the regulations. However, the IRS chose to adopt more restrictive regulations by providing that the characterization of an organization was to be determined by state law.[34] This provision prevented professional groups organized in states which had adopted the Uniform Partnership Act from achieving the necessary corporate characteristics. The IRS maintained that continuity of life, centralized management, limited liability, and free transferability of interest were not possible for an organization subject to the Uniform Partnership Act.[35]

In an effort to overcome the "Kintner Regulations," professional groups attempted to persuade state legislatures to enact special legislation permitting professional incorporation.[36] The resulting legislation varied from state to state, but each jurisdiction enacting such legislation attempted to allow professional groups to form either associations or incorporated organizations which possess the requisite corporate characteristics.[37] These acts, since drafted in response to the regulations, normally create at least three relationships which will qualify under the criteria to be used in determining corporate status.[38]

Before the validity of the original "Kintner Regulations" could be determined by court decision, they were amended in 1965 and a new paragraph was added which, in effect, denies corporate status to all profes-

[34] *Id.* § 301.7701-1(c).

[35] *Id.* §§ 301.7701-2(b)(3), (c)(4), (d), (e)(1). Since the Uniform Partnership Act defines a partnership as any "association of two or more persons to carry on as co-owners a business for profit," all unincorporated organizations, unless exempted under other state law, would fall within this definition. UNIFORM PARTNERSHIP ACT § 6.

Continuity of life cannot be achieved under the Uniform Partnership Act because the death, insanity, or bankruptcy of a member, or any act in violation of the partnership agreement, causes dissolution. *Id.* § 31.

Centralized management is not possible because of the mutual agency relationship created between the members of the partnership. *Id.* § 9.

Limited liability is not achieved by a professional partnership because all persons are jointly and severally liable for all acts chargeable to the partnership. *Id.* § 15.

Free transferability of interest does not exist because a partner can assign only his right to share in partnership profits, but cannot assign his right to participate in management. *Id.* § 27(1).

[36] Thirty-two states have enacted legislation that permits professionals to incorporate or form associations that do not fall within the provisions of the Uniform Partnership Act, and are therefore able to obtain federal tax benefits. CCH 1970 STAND. FED. TAX REP. ¶ 5943.0973.

[37] These acts, although providing other corporate characteristics, usually provide that they do not modify or alter the relationship between a professional and his client, including liability for services rendered. *See, e.g.*, FLA. STAT. ANN. § 621.07 (1961); GA. CODE ANN. § 84-4307 (1961); ILL. ANN. STAT. ch. 106-½, § 106 (Smith-Hurd 1961); OHIO REV. CODE ANN. § 1785.04 (Page 1961); OKLA. STAT. ANN. tit. 18, § 812 (1961). *Contra*, CONN. GEN. STAT. ANN. § 33-472(a) (1961); TENN. CODE ANN. § 61-105(3)(c) (1961). It may be argued that retention of the professional relationship creates individual liability for each member, but a more reasonable view of this provision would be that it merely reaffirms the liability of each professional for his own acts. *See* O'Neill v. United States, 281 F. Supp. 359 (N.D. Ohio 1968), *aff'd*, 410 F.2d 888 (6th Cir. 1969).

[38] Overbeck, *supra* note 22, at 1207. *See, e.g.*, FLA. STAT. ANN. §§ 621.05 (continuity of life), 621.13 (centralized management), 621.03, .09, .11 (transferability of interest) (1961); GA. CODE ANN. §§ 84-4309, -4311 (continuity of life), 84-4308 (centralized management), 84-4310, -4314 (transferability of interest) (1961); ILL. ANN. STAT. ch. 106-½, §§ 107 (continuity of life), 108 (centralized management), 109 (transferability of interest) (Smith-Hurd 1961); OHIO REV. CODE ANN. §§ 1785.08 (continuity of life), 1785.08 (centralized management), 1785.05 (transferability of interest) (1961).

sional service organizations.[39] This paragraph denies corporate status to an association if it is "subject to local regulatory rules which deprive such corporation of the usual characteristics of an ordinary business corporation."[40] This denial is apparently based on the theory that the various professional ethical codes and regulations do not permit the relationships essential to corporate status.[41]

The IRS's promulgation and subsequent amendment of the "Kintner Regulations" has been criticized as being "directly contrary to the assurances given by the service that the code is to be interpreted for the purpose of ascertaining its true meaning and not for the purpose of increasing tax collections."[42] This criticism also infers that the IRS, by adopting the regulations, has plainly exceeded its authority.[43] Such criticism seems valid if one is to believe, as the IRS states, that it is the duty of the Service "to try to find the true meaning of the [Code] and not to adopt a strained construction . . . ."[44] The courts had clearly determined the meaning of "substantial corporate characteristics" prior to the adoption of the "Kintner Regulations."[45]

The present "Kintner Regulations" have been held invalid in several court cases.[46] Generally, these cases emphasize that a professional organization has the status of an unincorporated association and that the Commissioner's attempts to classify them as partnerships conflict with the Internal Revenue Code definition.[47] One court found that there was no rational ground for distinguishing professional service organizations from non-professional service organizations, and concluded: "The discrimination perpetuated in the regulation is not supported by the statutes, judicial precedent, or sound tax policy. In short, the regulation is an instance of *administrative overreaching*."[48]

As a result of these court defeats, the IRS decided to give up the battle and allow doctors, lawyers, and other professionals organized under state professional association or corporation acts to be treated as corporations for

---

[39] Treas. Reg. 301.7701-2(h) (1965).

[40] This limitation and other concepts included in the 1965 amendments to Treas. Reg. 301.7701-2 were originally proposed and extensively discussed in Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1 (1961).

[41] Overbeck, *supra* note 22, at 1207-08. This theory is of doubtful validity with regard to most professionals and has been specifically rejected by at least one professional group (American Bar Association) charged with policing the conduct of its members. 51 A.B.A.J. 402 (1965).

[42] Overbeck, *supra* note 22, at 1209.

[43] *Id.*

[44] *Id.* at 1209, citing Rev. Proc. 64-22, 1964-1 CUM. BULL. 689.

[45] Morrissey v. Commissioner, 296 U.S. 344 (1935). *See also* Pelton v. Commissioner, 82 F.2d 473 (7th Cir. 1936), which applied these characteristics to a medical clinic.

[46] Holder v. United States, 289 F. Supp. 160 (N.D. Ga. 1968), *aff'd*, 412 F.2d 1189 (5th Cir. 1969); Kurzner v. United States, 286 F. Supp. 839 (S.D. Fla. 1968), *aff'd*, 413 F.2d 97 (5th Cir. 1969); O'Neill v. United States, 281 F. Supp. 359 (N.D. Ohio 1968), *aff'd*, 410 F.2d 888 (6th Cir. 1969); Empey v. United States, 272 F. Supp. 851 (D. Colo. 1967), *aff'd*, 406 F.2d 157 (10th Cir. 1969).

[47] "To treat as a partnership for federal income tax purposes a corporation, organized and chartered under the state laws as a corporation and operated as such in good faith, does violence to the statutory definitions of the terms 'partnership' and 'corporation,' to long followed administrative practice prior to 1965, and to decided cases dealing with analogous organization." United States v. Empey, 406 F.2d 157, 170 (10th Cir. 1969).

[48] O'Neill v. United States, 281 F. Supp. 359, 364 (N.D. Ohio 1968), *aff'd*, 410 F.2d 888 (6th Cir. 1969).

tax purposes.[49] The IRS qualified this announcement by stating that these professional organizations will "generally" be treated as corporations, and further provided that implementing instructions are to be issued on a state-by-state basis if necessary.[50] These qualifications apparently mean that the recently enacted TPAA[51] will be closely examined by the IRS to determine if it creates the necessary relationships between the members of the professional association. Presumably, the IRS will also examine, on a case-by-case basis, the specific entity concerned to determine if it operates in accordance with the state act.

II. CHARACTERISTICS INFLUENCING A DECISION TO FORM A PROFESSIONAL ASSOCIATION

The advantages and disadvantages common to all professional associations should be carefully considered before advising any professional to form an association. The present discussion is limited to the federal tax advantages and disadvantages, but there are also non-tax elements which should be considered. These non-tax elements primarily concern the effects of the corporate form of organization on the professional's practice and in some cases may be of sufficient importance to overcome the tax considerations. The attorney counselling professionals considering this business structure should emphasize its traditional advantages and disadvantages. These factors should be analyzed in light of the individual requirements and operating procedures of the organization to determine the advisability of forming a professional association.

A. *Tax Advantages*

Pension and Profit-Sharing Plans. Since a professional may now qualify as an employee of a professional association, he may invest up to fifteen per cent of his salary in a qualified[52] profit-sharing plan trust.[53] In addition, up to twenty-five per cent of the professional's salary may be invested if the plan combines pension and profit-sharing.[54] These percentages allow the amount contributed by the professional to be substantially greater than the $2,500 per year limitation for self-employed individuals under a "Keogh" plan.[55] Similarly, payments to a qualified plan on behalf of an employee are allowable expense deductions of the association;[56] the trust is not taxed on investment income;[57] and the employee is not taxed on his

[49] Technical Information Release No. 1019 (Aug. 8, 1969).
[50] *Id.*
[51] Tex. Laws 1969, ch. 840, at 2513, to be codified as TEX. REV. CIV. STAT. ANN. art. 1528F, §§ 1-24 (Supp. 1970).
[52] In order to constitute a "qualified" plan, a plan must meet certain conditions. One of these conditions is that "the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees." INT. REV. CODE of 1954, § 401(a)(4). *See also* Treas. Reg. § 1.401-1 (1964).
[53] INT. REV. CODE of 1954, § 404(a)(3).
[54] *Id.* § 404(a)(7).
[55] *Id.* § 404(e)(1).
[56] *Id.* § 404(a)(3).
[57] *Id.* § 501(a).

portion of the trust income until the year it is "distributed or made available" to him.[58] In effect, the professional obtains *tax exempt* profits for use in an investment trust and any income to this trust is also tax exempt until distributed. The trust may also provide a source of loans at reasonable rates of interest.

When investment income from a pension or profit-sharing trust is finally distributed to the professional, subject to certain limitations, it may be treated as capital gains.[59] Direct contributions to the trust for the benefit of the professional may be deferred and not repaid until he retires, when, presumably, his income tax bracket will be lower. Since the beneficiaries of the professional are also eligible for these tax benefits,[60] a lump sum distribution to them will not be subject to estate tax. This is also the situation with regard to gifts of the beneficial interest by the professional to other persons.[61]

Sick Pay and Medical Reimbursement Plans. The professional, as an employee of the association, may receive, subject to certain limitations, up to $100 per week from the association tax free under a wage continuation plan.[62] The association may also agree to reimburse the professional for all medical expenses.[63] The amounts expended by the association under either plan are not includable in its gross income.[64] The extent of such wage continuation and medical expense benefits can more readily be appreciated by comparing them with those available to a self-employed person. The self-employed may deduct from income only those amounts expended for medical expenses in excess of three per cent of adjusted gross income.[65]

Death Benefits and Group Insurance. A professional association may provide tax free payments of up to $5,000 to the beneficiaries of a professional employee,[66] and, within certain limits, the association may purchase group life insurance for all employees and the premium payments are not taxable to them as income.[67] Both of these contributions are also not includable in the gross income of the association, since they are paid pursuant to qualified plans. There are, however, some restrictions placed on the deduction of amounts paid in connection with certain insurance contracts. An association is not allowed to deduct premiums paid on any life insurance policy covering an officer, employee, or any person financially interested in the business of the association if the association is directly or indirectly a beneficiary under the policy.[68] This restriction prevents the

[58] *Id.* § 402(a)(1).
[59] *Id.* §§ 402(a)(2), 403(a)(2), 72(n).
[60] *Id.* § 401(a).
[61] *Id.* § 2517(a).
[62] *Id.* § 105(d).
[63] *Id.* § 105(b).
[64] *Id.* § 106.
[65] *Id.* § 213.
[66] *Id.* § 101(b)(1).
[67] *Id.* § 79(a).
[68] *Id.* § 264.

creation of a form of tax deductible "key-man" insurance by insuring the lives of member professionals to protect the association from loss in the event of their death.

Simplified Tax Withholding, Reporting, and Accounting. The professional's tax payments, as an employee of the association, are taken directly from his salary.[69] The professional is, therefore, allowed to pay the tax immediately when it becomes due and is not required to make the normal quarterly estimated tax payments of self-employed individuals.[70]

Furthermore, the professional is no longer required to file the customary supporting schedules and documents with his income tax reporting forms since the income derived from his services belongs to the association. He may also be reimbursed for all business-related travel and entertainment expenses, and is not required to report as income reimbursements from the association for those amounts actually expended.[71]

A professional association may avoid corporate taxation by electing to be taxed as a Subchapter S corporation if there are no more than ten shareholders.[72] This election, in effect, treats the entity as a partnership for tax purposes.[73] Although the tax rate for a corporation is normally lower than the rate for an individual with a substantial income,[74] in certain situations taxation as a partnership through a Subchapter S corporation may be preferable. For example, a group of doctors beginning practice may reasonably anticipate little income or even losses during initial operation due to a probable lack of patients and the large expenditures necessary to obtain offices and equipment. Qualification as a Subchapter S corporation would allow the doctors to report as personal income their share of amounts earned by the association, but the association would not be required to report this income. Presumably, the doctors would be in a low income tax bracket and the corporate tax would be completely avoided.

Certain restrictions applicable to Subchapter S corporations may, however, reduce their desirability. An association electing Subchapter S taxation may have no more than ten shareholders[75] and only one class of stock.[76] These restrictions prevent manipulation of stock class as a control device, *i.e.*, voting rights, and limit equity participation to ten persons. This may be particularly unattractive to professionals desiring to allow new members to share in profits while retaining control in a smaller group. An additional disadvantage of a Subchapter S election was created by a provision of the 1969 federal tax reform bill. This provision restricts the individual contributions to a qualified profit and pension-sharing plan in a Subchapter S corporation to $2,500.[77] Thus, by this election, an associa-

[69] *Id.* § 3402(a).
[70] *Id.* § 6153(a).
[71] *Id.* § 62(2).
[72] *Id.* §§ 1371-78.
[73] *See generally id.* §§ 1373, 1374, 1375, 1377.
[74] *Compare id.* § 1, *with id.* § 11.
[75] *Id.* § 1371(a)(1).
[76] *Id.* § 1371(a)(4).
[77] *Id.* § 1379.

tion loses one of the most substantial tax advantages and receives substantially the same treatment as a single practitioner or partnership under a "Keogh" plan.

Simplified Estate Planning. When a member of an unincorporated professional practice dies, the value of his practice to his estate decreases substantially. The estate is ordinarily able to sell only his files and records, and the "going concern" value of his practice is usually lost. In a professional association, however, the members may provide for the association to continue to exist and operate after the death of a member.[78] This continuity creates a valuable capital asset for the estate of a deceased which may be disposed of according to a special redemption plan,[79] a written agreement between the shareholders, or by sale to another professional. Any gain on the sale of this stock may be reported as a capital gain or loss to the seller for tax purposes.[80]

B. *Tax Disadvantages*

Excess Accumulated Earnings. The temptation is to retain income in the association and not distribute it to the members in order to avoid income tax to them. This is especially true in the higher tax brackets since the corporate tax rate is usually lower than the individual rate. The association may accumulate up to $100,000 for any reason,[81] but funds in excess of that amount are subject to taxation as excess accumulated earnings[82] unless the association justifies the accumulation of these earnings by showing that the "reasonable needs of the business" require this accumulation.[83]

An excellent way to prevent taxation of retained income as excess accumulated earnings is to elect to be taxed as a Subchapter S corporation.[84] This type of organization allows the members to be directly taxed on the association's income and allows them to accumulate whatever amounts they desire as undistributed income without any requirement of showing a "reasonable need" of the business. Without a Subchapter S election, or a showing of a valid business purpose, all accumulated income in excess of $100,000 is suspect and should be distributed.

Non-Qualification of Pension and Profit-Sharing Plans. The requirements for the qualification of a pension, profit-sharing, or stock bonus plan are technical,[85] and the IRS will not issue advance rulings on the qualification of such plans.[86] This policy forces a professional association to establish the employee salaries, on which their contributions are based, without IRS

---

[78] TPAA § 8(B)(2).
[79] INT. REV. CODE of 1954, § 303.
[80] *Id.* § 1221.
[81] *Id.* § 531.
[82] *Id.* § 532.
[83] *Id.* §§ 534, 537.
[84] *See* notes 72-77 *supra*, and accompanying text.
[85] INT. REV. CODE of 1954, §§ 401(a)(1)-(a)(10).
[86] Rev. Proc. 64-31, § 3.01(1), 1964-2 CUM. BULL. 947.

advice as to their reasonableness. If an association deducts contributions to a plan over a period of years believing it qualifies for favorable tax treatment and in fact it does not, these contributions will be disallowed. As a result, the association will not be entitled to a previously deducted expense item;[87] the employee will be taxed immediately on the contributions of the association as income received;[88] and the income of the trust will not be considered tax exempt.

A common reason for the IRS determination that a particular plan fails to qualify for tax purposes is that it is discriminatory in favor of association officers or of higher-paid employees.[89] To avoid this problem, a pension or profit-sharing plan should include *all* employees of the association.

Personal Holding Company Classification. If an association is classified as a personal holding company under section 542 of the Code,[90] a tax is then imposed at the rate of seventy per cent of the "undistributed personal holding company income."[91] This income is extensively defined in the Code[92] and one of the items taken into account is amounts received under a personal service contract.[93] Since its product is "service," a professional association's income is suspect and may be subject to this provision unless all services are performed in the name of the corporation and member professionals do not maintain their own personal clients.[94]

III. Forming a Professional Association

A. *Planning Considerations*

Determining Who Will Be the Stockholders. In most situations, all of the professionals will acquire stock in the association. Possible exceptions will occur when there are senior members who are to have control or when there are more than ten members and they desire to qualify for Subchapter S tax status.[95] If it is determined that all the professionals are to be stockholders, the question remains whether they will own stock in proportion to their compensation. If compensation is to vary from year to year according to work accomplished, it would be difficult to adjust the stock holdings of members to match these variations. In addition, by adjusting the individual ownership interests yearly, the senior members are not allowed to retain a controlling proportion of the stock as their productivity decreases. While young association members would consider this an advantage, it seems unlikely that the senior members, who are probably

[87] Int. Rev. Code of 1954, § 404(a).
[88] *Id.* § 403(c).
[89] Rev. Rul. 67-341, 1967-2 Cum. Bull. 156.
[90] Int. Rev. Code of 1954, § 542(a).
[91] *Id.* § 541.
[92] *Id.* § 543.
[93] *Id.* § 543(a)(7).
[94] For a discussion of ways to avoid this problem, see notes 104-05 *infra*, and accompanying text.
[95] Int. Rev. Code of 1954, § 1371(a)(1).

in control of the organization when these decisions are made, would provide for ownership interests to vary yearly.

Related to the consideration of who are to be the stockholders is the problem of determining the method of payment for ownership shares purchased due to the death, termination, disability, or retirement of a shareholder. It will be difficult for new members beginning practice to raise sufficient funds to purchase their stock. They may not finance this purchase with past or future services without being taxed on the value of the stock as income in the year received.[96] It has been suggested that the new member finance the stock with a promissory note payable over a series of years.[97] Although this method violates the Texas law prescribing consideration to be given as payment for shares in a corporation,[98] there seems to be no prohibition against this method of payment for shares in a professional association,[99] and a promissory note should be acceptable.

Employment Contracts and Salaries. The members should each sign an employment contract with the association. This contract should cover the provisions normally included in a partnership agreement (vacations, restrictions against competition, forced resignations, etc.), and provide for the amount of salary to be paid to the member.

Determining the amount of salary to be paid to each member will be difficult. Since an association is limited to a "reasonable allowance for salaries" as a deduction,[100] a reasonable relation must be maintained between the services rendered by an employee and the compensation paid to him. It has been suggested that specific salaries must be established,[101] but it would seem reasonable to base compensation on a variable such as hours worked, billings, etc. This method would preclude problems encountered by fixed salaries.

By establishing fixed salaries, an estimate must be made of the amount to be available for these salaries during future periods if no retained earnings are desired. If a reasonable estimate is made, the member's percentage of this amount is his stated salary. Any amounts of income in excess of this estimate may be paid to him as a bonus; but since bonuses are usually excluded from computations of income paid under most pension and profit-sharing plans,[102] care must be taken to estimate the base salary as high as possible. When salary estimates are too low in relation to actual income

[96] *Id.* § 61(a)(1). *See also* Treas. Reg. § 1.61-2(d)(4) (1966).

[97] O'Neill, *Professional Service Corporations: Coping With Operational Problems*, 31 J. TAXATION 94, 95 (1969).

[98] TEX. BUS. CORP. ACT ANN. art. 2.16B (1956).

[99] There is no specific restriction as to the type of consideration that may be paid for an association ownership interest; therefore partnership law governs, TPAA § 24, and there is no restriction of any kind with regard to the consideration to be paid for a partnership interest.

[100] INT. REV. CODE of 1954, § 162(a)(1).

[101] O'Neill, *supra* note 97, at 96.

[102] Bonuses are usually excluded from computations of income because, under certain circumstances, their inclusion for qualified plan purposes will result in plan disqualification. This occurs when the technical IRS definition of compensation is not applied by the employer. Rev. Rul. 59-13, 1959-1 CUM. BULL. 83; Rev. Rul. 68-454, 1968-2 CUM. BULL. 164; Rev. Rul. 69-145, 1969 INT. REV. BULL. No. 13, at 10.

available, bonuses paid as distributions of this income are not considered as compensation to the employee, and he forfeits a substantial advantage of being an association member. The association members may wish to establish small salaries because they are in a high individual tax bracket. If the IRS determines that these salaries are too low, it may reallocate the association income "to prevent evasion of taxes or clearly reflect the income"[103] of the member and the association. Generally, if the salaries of the members are reasonably related to the services they perform for the association, these salaries will not be questioned by the IRS.

Daily Operations. The mere fact that a professional association is organized does not guarantee that the corporate federal tax benefits will be available. The IRS may determine that the association has no actual "corporate existence" and therefore is ineligible for these benefits under the "sham corporation doctrine."[104] In applying this doctrine, the IRS determines whether there is a valid business purpose for the corporate structure and if its day-to-day operations reflect its corporate existence. Practically, to reflect corporate existence the association should conduct its operations and exercise management and control through its organizational structure. The fact that the professionals are organized as an association should be clearly indicated by its stationery, statements to clients, contracts, insurance policies, bank accounts, telephone listing, etc. All business should be transacted in the name of the association rather than through individual members. Periodic meetings of the board of directors and shareholders should be held, and recorded minutes should be taken. These meetings should not be merely pro forma, and actual management should be exercised.[105]

Disposition of Stock. As discussed previously,[106] stock in the professional association is a capital asset of the member and is not affected by his death. This is a beneficial characteristic for a deceased member's estate, but it may create problems for the association when it has an option, or is required, to purchase a deceased member's stock.

If the articles of association provide for repurchase of a deceased member's stock by the association, the retained earnings of the association may be insufficient to finance this repurchase. This may also be true in the case of cross-purchase agreements between shareholders. Care must be taken to provide that either retained earnings or some form of "key-man" insur-

---

[103] INT. REV. CODE of 1954, § 482.

[104] "In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction." Moline Properties v. Commissioner, 319 U.S. 436, 439 (1943). *See also* Higgins v. Smith, 308 U.S. 473, 477-78 (1940); Gregory v. Helvering, 293 U.S. 465 (1935).

[105] A good example of a successful IRS attack on a pro forma corporation is Jerome J. Roubik, CCH TAX CT. REP. No. 36 (1969). In *Roubik* the tax court conceded the corporate form of a group of doctors but still allowed an IRS inquiry as to whether the corporation actually *earned* the income by control of the "employees" and management of the corporation's external affairs. The court found that the corporation existed merely "through the purely formal device of incorporating a set of bookkeeping sheets." *Id.* at 3475.

[106] *See* notes 78-80 *supra*, and accompanying text.

ance on the lives of the members is available to purchase this stock.[107] The use of retained earnings, in effect, requires each member to pay a portion of this cost, but reciprocal agreements among all the members may be used. These agreements would provide that each member purchase sufficient insurance to finance the purchase of his ownership interest in the event of his death. This insurance would be payable to the association and would be used by it to purchase the deceased member's stock. The primary disadvantage of this type of arrangement is the fact that the premium payments are not deductible by the individual members since they are personal expenditures.

B. *Meeting Internal Revenue Service Tax Requirements*

Although the IRS has apparently given up its long fight to tax as individuals professionals organized as associations or corporations under state laws, uncertainties remain for these organizations. The IRS will "generally" concede an organization's corporate character, but it will examine each organization individually according to the provisions of the applicable state law.[108] In the following discussion, the status of an association organized under the TPAA is examined in the light of the criteria prescribed by the IRS to determine if an organization has the necessary "characteristics of a corporation"[109] to qualify for corporate tax treatment.

Continuity of Life. The IRS will concede that an organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member does not cause a dissolution of the organization.[110] The TPAA allows professionals to create continuity of life in their articles of association.[111] Consequently, care should be taken to provide for such continuity when drafting the association's articles, since the statutory provision is merely permissive and partnership law applies in the absence of such a provision.[112] If partnership law is applied, several occurrences may cause dissolution and continuity of life is not achieved.[113]

Since the TPAA provides that "any *one* or more persons duly licensed . . . may . . . form a professional association,"[114] the single professional desiring to form an association must also create a method for maintaining continuity of life if he is to conform to the IRS test. One solution to this problem is to provide a reciprocal work-continuation agreement with another professional accompanied by a nominal interest in the association. This enables the one-man association to create at least arguable continuity of life.

Centralization of Management. To have centralized management, the

[107] However, see note 68 *supra*, and accompanying text, for a discussion of the limitations on "key-man" plans.
[108] Technical Information Release No. 1019 (Aug. 8, 1969).
[109] Treas. Reg. § 301.7701-2(a) to -2(e) (1965).
[110] *Id.* § 301.7701-2(b)(1).
[111] TPAA § 8(B).
[112] *Id.* § 24.
[113] UNIFORM PARTNERSHIP ACT § 31.
[114] TPAA § 2(A) (emphasis added).

IRS contends that an organization must be governed by a person or persons (not including all members) who have "continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed."[115] In Texas, a professional association is governed by a group of directors or an executive committee elected by the members "so that centralization of management will be assured."[116] This provision seems to provide the requisite centralized management, but the association must actually operate within this statutory scheme and maintain its "corporate existence" to satisfy the IRS.[117]

Free Transferability of Interests. An association has the necessary characteristic of transferability of interest if each member has the power, without the consent of other members, "to substitute for themselves in the same organization a person who is not a member of the organization."[118] The TPAA specifically provides that the transfer of membership to a new member or members does not work a dissolution.[119] It also provides that shares or units of ownership are transferable to persons licensed to perform the same type of professional service.[120] It seems that these provisions provide sufficient transferability; however, the drafter of articles of association should avoid provisions that limit the right of a member to share in the profits of an association to the existence of an employment relationship between them. A provision of this nature restricts transferability unless the member may transfer *both* the right to receive a share of the profits and the right to the employment relationship.[121]

Limited Liability. If no member of the association is personally liable for any debts or claims against the organization under local law, the organization has limited liability.[122] Personal liability exists if creditors of the association may seek satisfaction from association members to the extent that the assets of the association are insufficient to satisfy claims.[123] An association organized under the TPAA retains the traditional professional-client relationship for its members, including liability arising out of professional services.[124] Since an employee of any organization is personally liable for torts committed by him, it seems that the only effect of this provision is to create contractual liability for the professional who personally performs the services. This is the interpretation given by a federal court construing an Ohio statute identical to the Texas provision.[125] One troublesome aspect of the TPAA is the provision which applies partnership law to associations

[115] Treas. Reg. § 301.7701-2(c)(1) (1965).
[116] TPAA § 9(A).
[117] *See* notes 104-05 *supra*, and accompanying text.
[118] Treas. Reg. § 301.7701-2(e)(1) (1965).
[119] TPAA § 8(B)(2).
[120] *Id.* § 10.
[121] Treas. Reg. § 301.7701-2(e)(1) (1965).
[122] *Id.* § 301.7701-2(d)(1) (1965).
[123] *Id.*
[124] TPAA § 7.
[125] O'Neill v. United States, 281 F. Supp. 359 (N.D. Ohio 1968), *aff'd*, 410 F.2d 888 (6th Cir. 1969).

unless it is inconsistent with the Act's basic provisions.[126] Thus, unless there is a provision in the Act specifically protecting association members from traditional partnership liability, limited liability is not present. Section 9(B) of the Act[127] seems to establish the requisite limited liability for shareholders by providing that a member has no power to bind the association within the scope of its business merely by being a member.

IV. CONCLUSION

An association organized under the TPAA has all of the characteristics of a corporation prescribed by the IRS. The treasury regulations state that an unincorporated organization "shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics."[128] Under this test, a Texas association seems to qualify objectively as an organization entitled to receive corporate tax treatment since it has the characteristics of continuity of life, centralization of management, free transferability of interests, and limited liability. Thus, the long fight with the IRS as to the *right* of professionals to incorporate is apparently over.

Even though an organization qualifies with regard to the statutory framework, it remains to be seen how often and to what extent the IRS will actually examine a specific association to determine if it operates within this framework.[129] Professional associations are still vulnerable to attack if they do not operate as such.[130] Professional "employees" must ensure that their normal activities conform to this organization and control is exercised by the association. This will require a change in the basic philosophy of the member professionals and cause a different relationship with existing clients. Some of these clients may find this relationship too impersonal. The professional, and his legal advisor, considering a change to this organizational form must consider these elements and weigh their effects on his particular practice against the several advantages of professional associations.

[126] TPAA § 24.
[127] *Id.* § 9(B).
[128] Treas. Reg. § 301.7701-2(a)(3) (1965).
[129] *See* notes 104-05 *supra*, and accompanying text.
[130] *See* Jerome J. Roubik, CCH TAX CT. REP. No. 36 (1969).